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Ways Donors Can Help the Evolution of Sustainable Microfinance Organizations

by

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Abstract

This paper suggests ways donors can help the evolution of sustainable microfinance organizations. Sustainability is good because it helps MFOs help more poor people than otherwise. Sustainability is hard because it requires balancing outreach and sustainability with prices the poor can afford yet high enough to cover the costs of the MFO. Donors are like genetic engineers whose job is to speed the evolution of sturdy MFOs. Technical assistance is the best way to tinker with MFOs.

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1. Introduction

Donors in microfinance are like genetic engineers. They should speed the evolution of the sturdy microfinance organizations. Donors believe that evolution by trial-and-error in a *laissez-faire* market would take too long. For example, donors can disseminate lessons from mistakes of MFOs trying to strike a balance between outreach and sustainability. This cross-pollination not only helps mistakes die out by letting MFOs learn from others' mistakes, but it also helps to replicate the strong features of good MFOs while deepening the pool from which healthy MFOs can emerge.

Donors have limited comparative advantages in quickening the evolution of stout MFOs. Donors are good at giving funds, measuring progress, and spreading good practice through technical assistance. Measuring progress and giving technical assistance spark better experimentation than giving funds. Funds are like food; MFOs feed and get bigger. Technical assistance is like school; MFOs learn and get better.

Donors husband microfinance by creating an environment that rewards success and punishes failure. To culture strains of MFOs that balance sustainability and outreach, donors must lubricate entry and exit (Von Pischke, 1992).

Experiments to strengthen MFOs are not safe. Progress may come only after costly mistakes, if it comes at all. Experimental MFOs may mutate into financial Frankensteins, well-meaning but blundering monsters doing more harm than good. Although donors work outside the market, they must mimic market forces so as to iron-out wrinkles and weed out experiments headed for dead-ends.

Section 2 defines *sustainability* and discusses the importance of profits. Section 3 discusses why measuring sustainability helps sustainability. Section 4 discusses how different forms of help from donors impinge on sustainability. Section 5 concludes.

2. What is sustainability?

Sustainability is the ability to repeat performance. A sustainable MFO is permanent, but it is not constant; its organization and its structure of incentives must be flexible so that managers can

adapt and adjust to keep performing well in a shifting environment. Sustainable MFOs meet their goals now without harming their ability to meet their goals later.

Performance is fulfilling the mission of microfinance. *Microfinance* is the sale of small loans and deposits. *Outreach* is the production of microfinance. The *mission of microfinance* is to help poor people by cutting the cost of outreach. An MFO helps the poor if it makes outreach cheaper than traditional banks.

Society is all people in the world. The goal of society is to maximize social welfare. *Social welfare* is social benefits less social costs. An MFO is *worthwhile* from the point of view of society if it makes more social benefits than social costs. Donors get resources taken by governments from rich taxpayers in high-income countries and give them to MFOs selling to the poor in low-income countries. Society may weigh benefits for the poor more than costs for the rich.

Sustainability matters because society cares about the poor now and in the future. Unsustainable MFOs might help the poor now, but they will not help the poor in the future because the MFO will be gone. Unsustainable MFOs might not even help the poor now (Adams *et al.*, 1984). Unsustainable MFOs might be worse than no MFOs at all because they may hurt exactly those they wanted to help (Krahnen and Schmidt, 1994).

Sustaining performance takes true profits. *True profits* are what accounting profits would be if the MFO paid for the opportunity cost of its resources, did not get any grants counted as revenue, and did not get any grants in kind not counted as expenses.

Just as infant firms need venture capital, infant MFOs need subsidized resources from donors. But fledgling MFOs need to be weaned fast because donors will soon abandon them in the marketplace. Access to subsidized resources waxes and wanes as donors tire and as political moods swing. Donors are fickle, and they will withdraw. Without profits, an MFO will shrink and die.

Even if subsidies were permanent, sustainability would still help fulfill the goal of society. After all, the poor are plenty but the donor dollars are few. Without profits, MFOs cannot attract private capital and so cannot saturate the market for microfinance (Rosenberg, 1994). Selfish investors will not start MFOs from scratch unless subsidized MFOs are profitable. If MFOs are so profitable they attract private investors, then outreach would mushroom. Social benefits would skyrocket, and social costs would shrivel. Social welfare would improve.

Sustainability, profits, and repayment are linked. Losses are the symptoms of a sick MFO, and borrowers will stop repayment. This weakens the MFO unto death.

The drive for profits is tempered by the mission to sell outreach to the poor. An MFO that abandons the poor by selling big loans and big deposits is not a sustainable MFO because it no longer lives as an MFO. Without the poor, MFOs are just banks. MFOs must walk a tightrope, balancing the poor and profits (Hulme and Mosley, 1996).

3. Why measuring sustainability helps sustainability

Measurement sparks good performance and casts light on bad performance (Von Pischke, 1996). Measurement of sustainability is a tool that can help donors build sustainability in at least five ways.

First, measurement forces the explicit definition of goals. Vague goals wither under attempts at measurement. Abstractions like *sustainability* can become buzzwords unless anchored in the nuts-and-bolts of measurement.

Second, measurement changes goals. Managers and donors who measure profits cannot help but worry more about profits.

Third, measurement exposes priorities. Willingness to measure sustainability shows willingness to work toward it. MFOs learned that success was only disbursing money when that was all donors measured.

Fourth, measurement helps management. Technical feedback helps detect trends, set targets, and make benchmarks for comparisons with peers (Richardson, 1994; Koch, 1992).

Fifth, measurement proves what microfinance can do. Donors are pressured to demand sustainability from MFOs. Without measurement, however, donors will be pestered by the fear that sustainability may be, in fact, impossible. Hesitant donors will expect less and get less from MFOs. A few recent success stories offer the tempting vision of sustainable MFOs (Gonzalez-Vega *et al.*, 1997; Khandker, 1996; Chaves and Gonzalez-Vega, 1996; Christen *et al.*, 1995). This dares donors to measure progress toward sustainability.

Sustainability, worthwhileness, and pseudo-benefit-cost analysis

Sustainability is sufficient, but not necessary, for worthwhileness. Profits are necessary, but not sufficient, for sustainability. It follows that there is not necessarily any relation between profits and worthwhileness (Figure 1).

Still, society wants donors to maximize worthwhileness. If MFOs are worthwhile, then their level of worthwhileness will be maximized by sustainability. This is because the profits of sustainable MFOs can attract private investors who can fund more and bigger MFOs than donors ever could.

Measuring worthwhileness requires benefit-cost analysis which requires measuring both benefits and costs. A sustainable MFOs is known to be worthwhile without benefit-cost analysis. But most MFOs are not yet sustainable. It is not enough to know that benefits are positive for these MFOs because costs are also known to be positive, and costs could be more than benefits.

Measuring costs is less cutting-edge than measuring benefits. The nitty-gritty details loan-loss provisions, tracking subsidies, and assuming opportunity costs are boring. But mistakes in measuring costs kill because they lead to non-sustainable MFOs. Mistakes in measuring benefits are not so fatal. Luckily, measuring costs is cheaper than measuring benefits (Adams, 1988; David and Meyer, 1983). This is true even though the cost of measuring benefits is falling (Hulme and Mosley, 1996; Pitt and Khandker, 1996; Bolnick and Nelson, 1990).

Measuring benefits requires a lot of good data from surveys of people before and after using the MFO and/or surveys of users and of identical non-users at a point in time. This takes a lot of time, money, and care. Complicated econometrics is needed to wipe out the effects of self-selection and fungibility (Moffitt, 1991; Von Pischke and Adams, 1980).

In contrast, measuring costs requires financial statements, talks with donors and accountants, and time at a desk. The math is straightforward. If opportunity costs are defined from the point of view of society and not from the point of view of the MFO and if past social costs are sunk, then the measure of subsidy in the framework of the Subsidy Dependence Index of Yaron (1992a and 1992b) measures social costs in a period.

Pseudo-benefit-cost analysis asks how high the surplus of the users of an MFO would have to be to make social benefits more than social costs. The analysis can span either from birth to the present or from the present to the future.

Pseudo-benefit-costs analysis is cheap for three reasons. First, it is cheap to measure social costs in the framework of the SDI. Second, it is cheap to measure the average dollar-years of debt or of deposits produced by an MFO. Third, the average social benefit of the average borrower or depositor is a multiple of the average debt or deposits outstanding, so the costs of measuring benefits can be skipped. Gale (1991) and Binswanger and Khandker (1995) use pseudo-benefit-cost analysis to look at subsidized finance. If the benefit-cost rule itself were judged by a benefit-cost rule, measuring only costs without benefits may beat measuring both benefits and costs.

Humans must judge sustainability

A negative SDI is necessary, but not sufficient, for sustainability. Sustainability happens over time in the unknown future. One year of serving the poor with profits does not imply continued good performance any more than one year of marriage implies happily ever after.

Quantitative measures inform the qualitative assessment of sustainability by a human analyst. Forecasting future performance takes human work and smarts because it is holistic, synthetic, and idiosyncratic. Forecasts must be grounded in present and past performance and informed by the analyst's knowledge of the particular MFO and of MFOs in general.

Human judgement is also needed for pseudo-benefit-cost analysis. Only humans can judge whether the surplus needed to make the MFO worthwhile is so small that actual, unmeasured surplus is likely to be more.

Privateness is a signal of sustainability

Profits are magnets for private investors. Private ownership helps worthwhileness because private owners press for profits. Profits are necessary for sustainability, and sustainability is sufficient for worthwhileness.

Donors, even if they own shares, are not the same as private owners. Donors do not want dividends, nor do they plan to sell their shares for a gain. In contrast, private owners are blind to all but dividends and retained earnings. Unlike private owners, the people in donor organizations are not gambling with their own money, and their personal goals may blind them to the goals of society. It is more likely that an investor will be selfish than that a donor will be selfless.

Trades with private entities involve resources belonging to the traders. Private trades are repeatable and thus sustainable because the parties choosing to trade have made a secret benefit-cost analysis and found that the benefits were more than the costs. If a trade is in the best interests of a private entity now, the safest assumption is that nothing will change in the future.

In contrast, trades involving non-private entities such as donors are not repeatable and thus are not sustainable because they are not selfish actions. The resources traded do not belong to the parties choosing to trade. Donors dole out funds wrenched from unwilling taxpayers.

Privateness is also a useful signal of healthy incentives. Useful indicators are the presence of private owners and a mission statement explicitly promoting profits and sustainability. The best signal of robust incentives is diverse, private funding sources, especially from deposits (Inter-American Development Bank, 1994; Chaves and Gonzalez-Vega, 1993).

4. The best ways to give subsidized resources to MFOs

Subsidized resources are not the same as subsidies. *Subsidized resources* are what donors entrust to MFOs at prices below their opportunity cost. *Subsidy* is the opportunity cost less what the MFO pays. All resources from donors are subsidized. Subsidies cannot be negative; an MFO would not hassle with a donor if it could trade on the market at a better price.

For example, suppose a donor lends an MFO L for a year at an interest rate of c. Let $m<c$ be the opportunity cost of a loan of like risk. The MFO gains subsidized resources from the loan equal to the opportunity cost less what is paid, $L\cdot(m–c)$. This is like an injection of equity because, without the loan, expenses would be that much higher and so equity that much lower.

The subsidy from the use of the subsidized resources is not $L \cdot (m-c)$ but rather $m \cdot L \cdot (m-c)$. The debt L is repaid and so is neither subsidy nor subsidized resource.

Subsidized resources are linked to subsidies in that subsidies from the use of subsidized resources become subsidized resources. For example, suppose an MFO got $m \cdot L \cdot (m-c)$ as a subsidy in a period. An unsubsidized MFO would have to pay this $m \cdot L \cdot (m-c)$ in the period, and, to keep from shrinking, it would have to increase its average debt in the period by $m \cdot L \cdot (m-c)/2$. This extra debt would cost the unsubsidized MFO $m^2 \cdot L \cdot (m-c)/2$. This is also a subsidy since it is a cost paid by an unsubsidized MFO but not paid by a subsidized MFO.

A typology of subsidized resources

An MFO can get subsidized resources in six ways. Three are explicit, and three are implicit (Figure 2). Explicit subsidized resources come from donor transfers. Implicit subsidized resources come from the MFO not paying opportunity costs.

The first four forms of subsidized resources are non-repeatable, and the last two forms are repeatable (Figure 2). When donors leave, MFOs repay only debt. Non-repeatable transfers end when a donor leaves, but repeatable transfers do not.

The first way an MFO can get subsidized resources is explicitly as a cash grant accounted for as equity. The subsidy is not the grant itself but rather the opportunity cost of the subsidized resources from the grant.

Second, an MFO can get subsidized resources explicitly as a cash grant accounted for as revenue. Grants are not revenue from operations, so all grants should be counted as injections of equity. Still, some MFOs misleadingly inflate profits by counting grants as revenue. Equity changes the same in either case. The subsidy is not the grant itself but rather the opportunity cost of the extra equity.

Third, an MFO can get subsidized resources explicitly as discounts on operating expenses from grants in kind. Examples include technical assistance, travel, training, cars, or computers. Discounts increase equity just like grants. The subsidy is the opportunity cost of the extra equity.

Fourth, an MFO can get subsidized resources implicitly as discounts on debt. The discount is the market price of debt of like risk less the price the MFO paid. The subsidy is not the discount but rather the unpaid opportunity cost of the use of the subsidized resources from the discount.

Fifth, an MFO can get subsidized resources implicitly as capitalized subsidies. Subsidies are like discounts on subsidized resources. Like equity injections, these subsidies become subsidized resources with an opportunity cost.

Sixth, an MFO can get subsidized resources implicitly as positive profits. Positive profits belong to owners. If positive profits are not withdrawn but left as positive retained earnings, then they have an opportunity cost just like any other form of equity. Negative profits do not have an opportunity cost. Negative profits are not claims by the MFO on owners, and they do not decrease the investment owners have sunk in the MFO.

Why the forms of subsidized resources matter

All six forms of subsidized resources have the same opportunity cost. Still, in addition to the explicit/implicit and repeatable/non-repeatable distinctions, the form of subsidized resources matters in at least seven ways.

First, discounts on operating expenses can change the production technology, shifting the average-cost curve down. Technical assistance is the most important example. A donor might pay for loan officers to be trained in a certain lending method or for managers to attend talks inculcating ideas the donor likes. Good technical assistance not only shifts the average-cost curve down but also makes it slope down more steeply as the MFO grows.

Second, grants of cash increase the funds the MFO can use as it likes. Growth slides the MFO along its average-cost curve. If all is well, costs fall.

Third, trading cash for shares gives donors some control over the MFO through seats on its board. Other forms of subsidized resources do not give this control. For example, the influence provided by a grant fades fast unless the donor tempts the MFO by dangling more grants. Having owners may also help the MFO to qualify for prudential regulation and supervision.

Fourth, the resources from grants in cash can be used to lend more. If there are non-fungibilities, then grants in kind may not lead to as much additional lending. Grants in cash may also dampen incentives to find market funds.

Fifth, discounts on operating expenses may pay for intangible assets. An example is technical assistance for training loan officers or for organizing management-information systems. These intangible assets are not in the accounts, but they bear fruit over time.

Sixth, explicit transfers are harder politically than implicit transfers.

Seventh, MFOs might spend cash without strings attached more wisely than they would use resources from in-kind grants with the same worth.

Why technical assistance is best

If the incentives of the managers of MFOs are the same as the incentives of donors, then donors should just grant MFOs cash without strings attached. After all, the MFOs would know their

own needs better than donors would. But the incentives of the managers rarely coincide with those of donors and/or society. Both want to help the poor, but managers also care about keeping their good jobs. Managers can secure their jobs at a much lower, much easier level of performance than what donors want to ensure worthwhileness. The opportunity cost of subsidized resources from the point of view of managers is the rate of inflation. This is lower than the opportunity cost from the point of view of society.

In general, donors should give subsidized resources as in-kind grants of technical assistance. If donors must give cash, they should buy shares. Shares give donors more control than all other forms of subsidized resources except technical assistance.

Technical assistance lets donors fine-tune the production technology while bestowing long-lasting, intangible assets. Technical assistance has the unique quality of letting donors target specific cogs in the present and future productive capacity of the MFO. For example, paying for training to help flexibility does not have the same effect as giving the same amount of cash without strings attached.

Technical assistance can also promote sustainability in ways cash cannot. Technical assistance can empower the MFO with tools, abilities, and incentives. It aims to solve the problems that keep the MFO itself from solving its problems.

There is still a role for financial assistance. In particular, financial assistance can motivate joining a program that otherwise stresses technical assistance. While money rations may be the spoonful or sugar that helps the medicine of technical assistance go down, MFOs must guard against addiction.

5. Concluding thoughts

Feedback makes markets work. It selects strong firms and strikes down weak ones. But the feedback loop between donors and MFOs is often blocked. For a time, donors can protect weak MFOs from being crushed by market forces. Donors must mimic market forces if they expect their MFOs to survive the inevitable move from captivity to the wild where it must fend for itself. Funds from donors should build organizations able to survive in the market without funds from donors (Rhyne and Otero, 1993).

Oddly, cartels among donors can improve competition among MFOs and thus speed evolution. Competition among donors wrecks incentives for sustainability by weakening threats to cut assistance. Competition also makes donors unwilling to push fledgling MFOs that are nearing sustainability out of the nest for fear another donor will grab it and take credit for its near-success.

In fact, just as those who already have credit are those most likely to get more credit, the MFOs that need donors the least are exactly those MFOs whose umbilical cord is the toughest to cut.

Cutting an MFO loose takes discipline by donors (Krahnen and Schmidt, 1994). Donor, examine thyself.

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Figure 1: Relations between Profits, Sustainability, and Worthwhileness

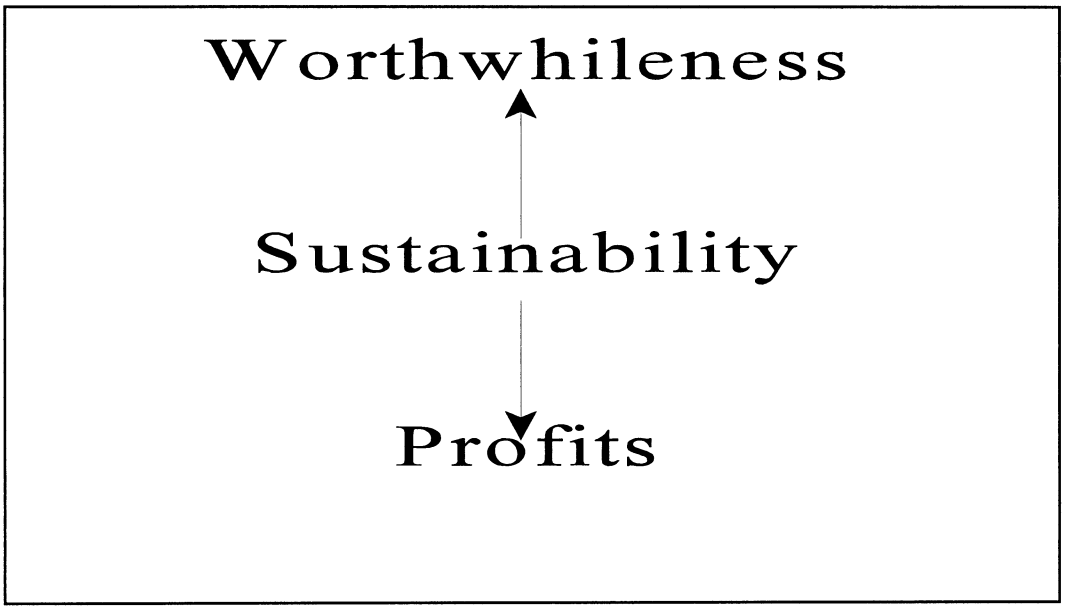

Figure 2: Ways an MFO can get subsidized resources

Form	Explicit or implicit	Repeatable or non-repeatable
1. Grants accounted for as equity 2. Grants accounted for as revenue 3. Discounts on operating expenses	Explicit	Non-repeatable
4. Discounts on debt from donors 5. Capitalized subsidies 6. Positive profits	Implicit	Repeatable